

The world has changed, most people just don't see it

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Since the financial crisis of 2008, the attention of too many investors in the West has become focussed on the expectation of persistently low and lower interest rates, and ever higher valuations for equities in companies imbued with a lot of future hope value. All other things being equal, technically, a lower interest rate (the factor by which future cash flows are discounted) increases the current value of future earnings, which in turn leads to higher equity prices.

At the same time the monetisation of the internet by technology companies, has extrapolated investors' expectations of higher rates of growth for future earnings, whilst being discounted by a low and lower discount (interest) rate. In such an environment, investors have become fixated with the inexorable growth in the prices of US technology companies, and this has induced a laziness in the search for diversification of prospective returns from other sectors and other markets and regions.

At Tacit we were early investors in this positive dynamic for technology companies, as our analysis highlighted that two of the three drivers required for an equity price to rise were working in tandem. The three basic building blocks of equity market returns are: dividend yields, earnings growth, and momentum in the revaluation of a company. In 2010, most investors were still recovering from the 2008 financial crisis and were too nervous of innovative and disruptor companies such as Amazon that were not fully understood. But their strong earnings growth, year-on-year, combined with falling interest rates were a perfect opportunity for investors who could see beyond the status quo of the time. One of our most successful investments in this cycle was Scottish Mortgage Investment Trust.

In a similar way, we believe that the pandemic has left people nervous of the future, and the current inflationary spike has made them fearful. We cannot know when the current drivers of inflation will abate, especially in the UK, but we can consider how opportunities will shift as the loose money environment of the past is replaced by tightening and higher interest rates. Economic theory suggests that capital is efficiently allocated to generate the highest returns. We believe that the artificial compression of interest rates through central bank intervention over the past decade-and-a-half does not add up to a normal economic environment. Interest rate policy has inflated expectations for future returns on equities which has encouraged excessive risk taking.

So, whilst others are looking for a lower entry point into the same companies that they owned in the last economic cycle, at Tacit our analysis tells us that the opportunity is elsewhere, namely Asia.

As with emerging technology disruptors fifteen years ago, many investors are nervous of Asian investment, be it China's lack of transparency or the geopolitical tensions in Taiwan, Asia is not an easy region for UK investors to get comfortable with. However, since the Asian Financial Crisis in 1997, the true picture is that most Asian economies have become more transparent and their governments have embraced risk aversion in their economic practices, running balanced budgets with strong discipline around their current accounts. This provides a stable environment for companies to grow, without the worry of economic downturns induced by governments mismanaging their economies. During periods such as now, it would normally be expected that most Asian economies, and in turn their equity markets, would perform worse than those in the West as they are deemed 'emerging economies' by most investors. This has not been the case though this challenging year.

Remember, equity returns are made up of three components: dividends, earnings growth and changes to the valuation of a company. Our analysis shows us that, like the factors in 2010 for technology companies, many domestically focussed Asian companies have two of the three components required to rise substantially once the current inflationary spiral in the West subsides and global demand rises again. The growing populations and pro-growth economic agendas in Asia provide a good backdrop for earnings growth in companies in the region.

It is important to look forward during periods of significant uncertainty. Strong future real returns are born during periods of distress. We cannot forecast when international investors will recognise the positive story for Asia, but we can position our strategies for it through carefully and thoughtfully selected opportunities. This is how we seek to provide our clients with the highest probability of achieving their investment goals and personal objectives.

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